DOW THEORY LETTERS INC.

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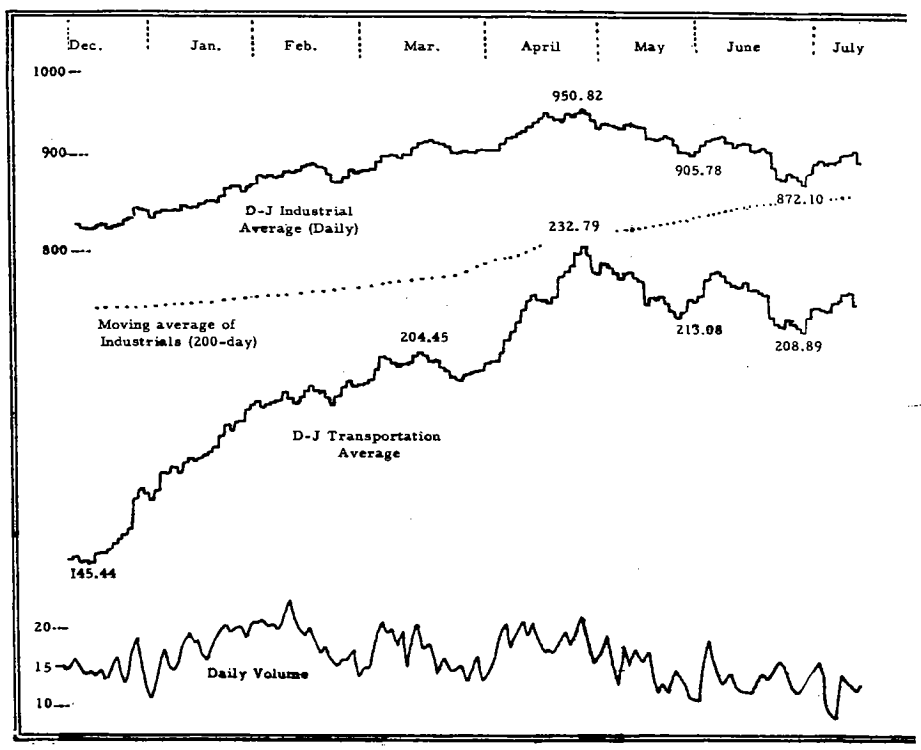
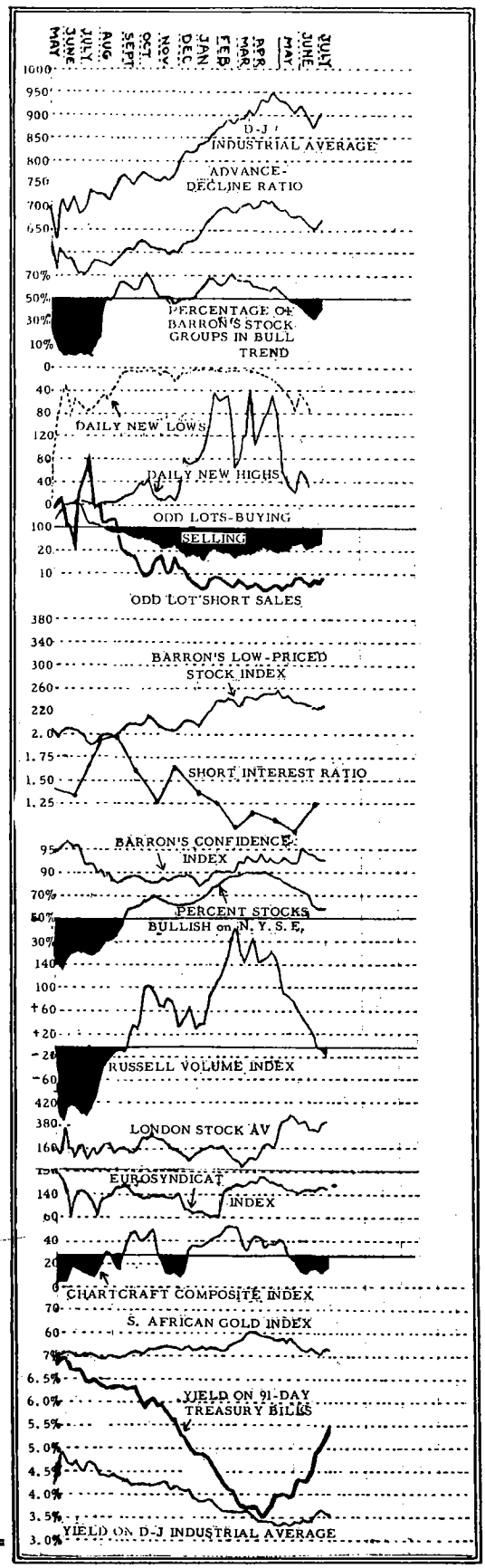
THE PICTURE: On July 8 the Administration officially abandoned its economic recovery goals. In testimony before the Joint Economic Committee, Paul McCracken (Chairman of the President's Council of Economic Advisers) said that inflation would be revived if "the targets previously put forward" were to be reached. He added that the Administration had added about $7 billion to the $11.6 billion deficit which was planned for fiscal 1972. McCracken stated that the money supply grew at a 10.5% rate during the first half of 1971, and that he was afraid that this could stir up inflation.

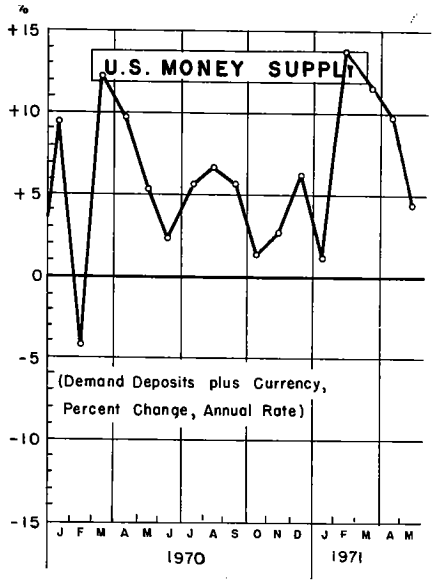
Senator Proxmire retorted that he did not understand how the Administration could be worried about inflation caused by excess demand "when plant capacity is at 75%, with 90% preferred, and when 5.5 million people are out of work".

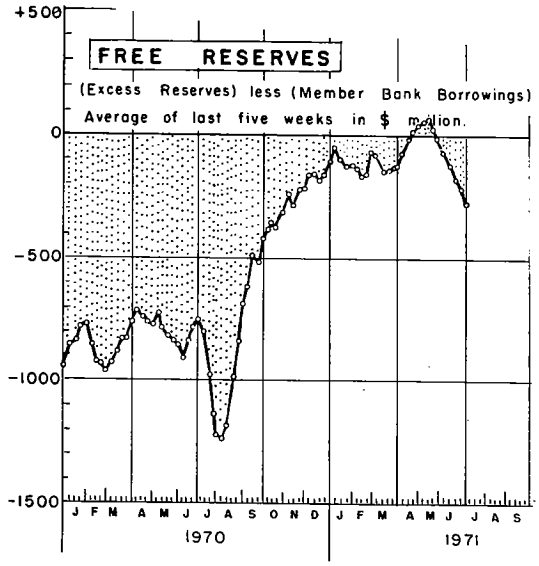
And that is the dilemma of the Administration right now. As a rule, a big jump in the money supply shows up in the form of inflation after about six months. Thus, it is probable that for the rest of this year inflation is going to be running rampant, and this, of course, is what Dr. Burns of the Fed knows. Dr. Burns has been pushing unsuccessfully for wage and price controls. Mr. Nixon does not want them. So here is the Fed, having pumped up the money supply at the fastest rate since World War II, and waiting for even worse inflation to come. And no controls.

Next step; a braking of the money supply, which can be expected for the rest of 1971. I include two charts (page 2) showing the trend of Free Reserves (which is now down) and the trend of the money supply on a year-to-year basis (also down). The charts are from Merrill Analysis, Box 228, Chappaqua, N.Y. 10514.

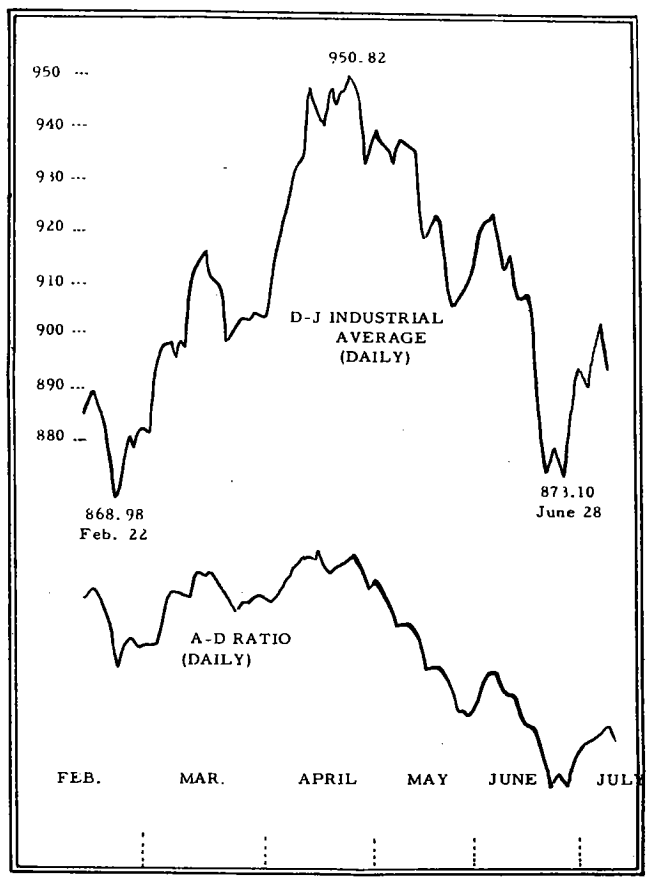







+500
0
-500
-1000
-1500
FREE RESERVES
(Excess Reserves) less (Member Bank Borrowings)
Average of last five weeks in $ million.
J F M A M J J A S O N D J F M A M J J A S
1970
1971

One immediate result is a rise in interest rates. From the lows of 1970, the 91-day Treasury are up around 60% in yield to 5.4% (see bottom of large page 1 chart). Last week New York paid 7.58% interest on $35 million of bonds, the highest rate in the city's history. Most competent observers are now amazed that interest rates "can be so high so early in the recovery". My comment is that we haven't seen anything yet. With Government running the biggest peace-time deficits in history, with business borrowing continuing high and with every city and country and state needing cash badly, with the Fed trying to put the brakes on inflation, we are going to see interest rates heading for the highs again, and this time the economy will be in worse shape than in 1969, when interest rates last rose through the roof.



Meanwhile, the "summer rally" in the stock market began on June 28 with the Dow Industrials at 872.10 and the Transports at 208.89. In the last few Letters I have been warning of the sluggishness and resistance to the upside on the part of the majority of N.Y.S.E. issues. I also suggested that attention should be focused on the advance-decline ratio as the rally got underway.

All last week (week ending July 9) despite the fact that the Dow advanced on each of the four trading days, declines were above 500 on each day. Or another way of measuring the upside resistance is to state that issues unchanged and declining outnumbered issues advancing on every day of that week. This despite the fact that the Dow gained 11 points for the week.

The latest week (week beginning July 12) started the same way with the Dow up 1.60 (Monday) on a sick plurality of 66 advances over declines. Tuesday saw a broad plunge with the Dow down 11 points, as the advance-decline line dropped precipitously and 1069 stocks declined. The weakness carried through to Wednesday, and the picture can be seen clearly on the accompanying chart. Note that the advance-decline line is well under its May low and far below its February low.

The fact is that so far on the "summer rally" the great majority of stocks have refused to join the upside with anything like conviction. This was underscored on Tuesday's sharp sell-off (July 13) as the first market decline in 10 trading days brought in more new lows than new highs! A switch to more new lows on the first day of decline signifies to me that this summer rally has evinced little strength, and that the market will need much more upside momentum than we have seen so far if it is to head off trouble over the next month or so.

Note on the page 1 chart that for the first time since August, 1970, the Russell Volume Index is in minus territory, and this signifies major selling pressure. The Chartcraft Composite Index, based on 28 leading technical indicators, is also below the 50% level, indicating a plurality of bearish indices. I also note that professional (investment advisory publication) sentiment has turned very bullish, and all reports have been "Go" for the big summer climb. This I take as another negative consideration.

In all, I believe we are faced with a long, tedious and ultimately heart-breaking primary bear market. Here we are, more than five years from the 1966 bull market top, the Dow is still within 100 points of its bull market peak, and like the Johnson Administration, the Nixon Administration (understandably) is fighting every economic weakness with a new barrage of money, words and promises. Nevertheless, I sense the growing public cynicism and discouragement, and in the end the bear will win. In the meantime, the long, tedious, second phase of the bear market continues, and very few are aware of the big picture.

WHY THE BEAR MARKET? There is no one reason, or to put it another way, readers of these Letters know that there are dozens of reasons for this primary bear market. But without a doubt, I would say that one of the biggest reasons for the bear market and the great collapse to come is debt.

Let's take a single case, America's largest city, and my old home town, New York. Here's what the head of the Economic Development Committee (a non-profit "think" outfit) recently said about Gotham: (see news clip)

So New York, which now lives on Federal and state handouts and new bond issues, goes limping along. But for how much longer is anyone's guess. And New York is typical of a great many cities, municipalities, counties and states in this nation.

"Ten years ago, New York City had 253,000 employes with a total payroll of $1.2 billion and an expense budget of $2.4 billion. Today it has 413,000 employes with a total payroll of $3.4 billion and an expense budget which may range between $8 billion and $9.3 billion in the coming year."

In that period of time, he said the city's population had not doubled or tripled as might be imagined. Instead it was approximately where it was 10 years ago — very close to 8 million.

As 1971 heads into its second half, the debate continues as to whether the economy is really moving up or whether the Government is simply playing with the statistics and indulging in wishful fantasies. So far, it has been established that the current recovery is the weakest one since World War II (unless it manages to gather steam in the months ahead). But there is one facet in the economic picture about which there is no doubt. And that is that the cost of attempting to "float" this soggy economy upwards is mounting to astronomical proportions. That cost can be measured in terms of debt.

Already, the most talked-about possibility for a boost to the sluggish 1971 economy is a tax cut. But here, President Nixon (probably remembering his conservative Quaker background) must gulp aloud. For with a 1971 Federal budget deficit which could easily reach $23-25 billion and another perhaps even bigger deficit slated for 1972, a tax cut could send the deficit so high that (aside from galloping inflation) sane-minded voters simply would not stand for it.

It should also be remembered that in the face of a sluggish economy, in the face of mounting debt, the Government has to deal with the rather extraordinary job of raising extra money this spring, at a time when the money vaults are usually overflowing with income-tax revenue. This is probably the factor which more than any other worries Rep. Mills, head of the Ways and Means Committee. Mills, long a "balanced-budget man", has been all along opposed to a tax cut, and Mr. Mills is the man who can enforce his will.

The latest Bank Credit Analyst is bullish on the intermediate term, but is not unmindful of the major or great cyclical picture. In his conclusion, editor Donald Storey states: "Storm clouds are on the horizon in the form of potential liquidity and interest rate problems. If profits, for some reason not presently discernable, do not rise rapidly, trouble could develop sooner than many seem to think". Thus Storey warns that a month by month scrutiny of the monetary picture is now mandatory, despite his intermediate-term optimism.

Less optimistic is Arnold C. Schumacher, economist for the staid Halsey Stuart & Co. I thought this piece (see page 4) from the July 5 Los Angeles Times was both fascinating and informative, and I include it inthe hopes that subscribers will study it carefully.

In closing this section, I want to include my long-term (annual high-low) chart of the widely-followed D-J 40 Bond Average. (see page 4). I do this on the basis that one picture is worth 1000 words. At any rate, here is a picture that's probably worth a few volumes (statistics, by the way, were supplied by expert bond and market student, C. Coleman Petty of Louisville). Note the long, brutal, collapse in the bond market, a bear market collapse which began in 1946. In this dismal price decline of the D-J 40 Bonds, we can trace the rise of inflation and interest rates since World War II.

Now study what occurred following the 1920 low and following the 1932 low. Those massive rallies in the bond market followed markets and economies which were fully liquidated. In other words, all the water had been squeezed out, the weak sisters had fallen, and the bond market was on a solid footing again. Here we see what bond market rallies look like after a primary bear market has actually terminated.

Now look at the rally following the 1970 "bottom". The D-J 40 Bonds have hardly budged above 71. Last week they fell back below 70 again. This is not the sort of action I would expect if 1970 saw the bottom of a 24 year bear market in bonds! Hardly, and I am sorry to say that Mr. Schumacher may be bold enough to be presenting the true story. It happens to be the same story that I have been telling for quite some time. If it's true, the bond market is going to go lower and the stock market is going a lot lower before the bear breathes its last.

"In 1969 the Federal Reserve—like a knight in shining armor—went forth to slay the dragon of inflation, but the fire breathing debt monster promptly chased the Fed back to the castle."

So says Arnold C. Schumacher, vice president and economist for Halsey Stuart & Co., Inc., Chicago. The Fed's failure, he adds, could send corporate bond interest rates over 13% within the next few years.

The unhappy fairy tale and Schumacher's gloomy warning both stem from recent sharp gains in outstanding debt, the economist says. Total public and private debt amounted to $1,840 billion at the end of 1970, he says, compared to $1,341 billion in 1966—a rise of 37% .

"Most analysts would agree that in the period from 1966 to early 1969, there was an unwarranted and unsustainable rise in borrowing," says Schumacher in his latest economic newsletter. "Credit standards were lowered. High interest rates were ignored in the rush to acquire funds. Inflationary expectations fueled the psychology of both borrowers and lenders."

This widespread and haphazard borrowing created rapid inflation, says Schumacher, and U.S. government figures seem to back him up.

Up until 1966, inflation had been running steadily below 2% annually (1.3% in 1961; 1.1% in 1962; 1.3% in 1963 and so on). In the last five years, however (in conjunction with Schumacher's "unwarranted and unsustainable rise in borrowing"), inflation has picked up sharply. Again according to government figures, prices rose by 2.7% in 1966, 3.2% in 1967, 4.0% in 1968, 4.7% in 1969 and 5.3% in 1970.

The rapid rise in public, corporate and individual debt, and the resulting gains in inflation, are now running almost out of control, Schumacher contends. "It's now at the point—total outstanding debt is so massive—that any attempt to control it are doomed to failure," he says.

"Indeed," he adds, "the only way the $1.8 trillion debt structure can be supported is through additions of still greater volumes of new debt, and probably at ever larger increments."

When the Federal Reserve Board tried to control inflation back in 1969 by tightening the money supply (which Schumacher says is really trying to cut back the total debt picture), business got so bad so fast, the Fed had to pull back.

"The restrictive money policy in 1969 showed how fragile the debt structure had become," says the Halsey Stuart economist. "Widespread liquidation and hardship were avoided in early 1970 only through a rapid shift toward an easier monetary policy."

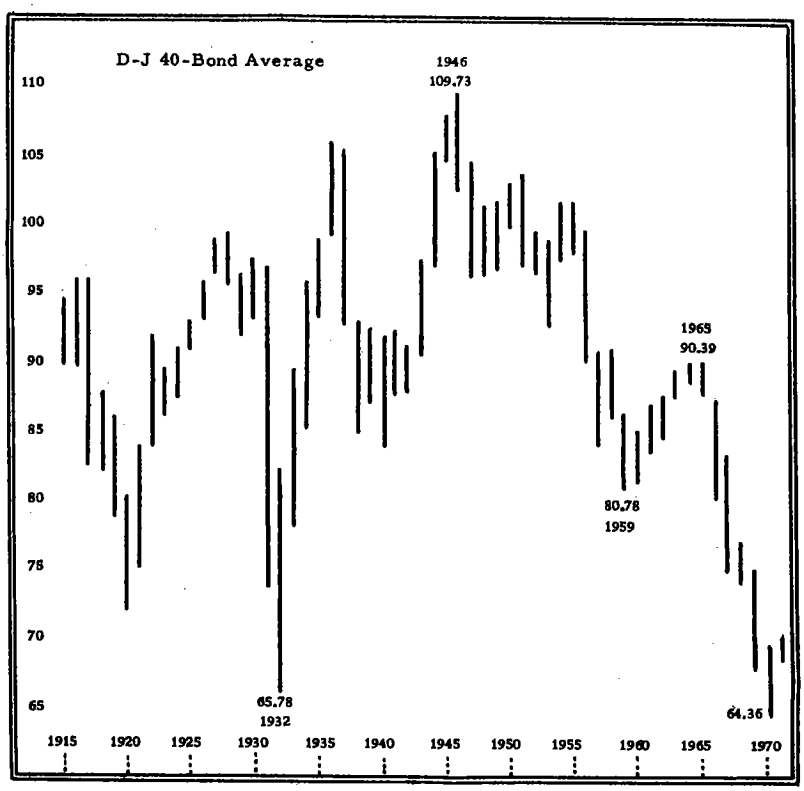
What all this means in Schumacher's opinion is more and more inflation, probably in the current range of from 4% to 6% annually, but perhaps as high as "7%, 8%, or 10%."

When one adds the 3% to 3.5% in real purchasing power which Schumacher feels investors must be assured before they'll commit funds for the purchase of bonds, corporate interest rates of up to 13.5% would not surprise the noted economist.

BY D. J. R. BRUCKNER

NEW YORK—Will the United States collapse? That question is commonly asked now rather than: Could it collapse? Such wide anticipation— a national public opinion study last month indicates that 47% of all Americans think the civil order may collapse—must spring from inequities felt by very large numbers of individuals. Most of us would rather think of problems to be solved, but many think of the same problems as reasons for abandonment of society, or for its destruction. Among the most acute problems which perhaps must be called prerevolutionary:

—Cost of living. Persistent inflation, whether slow or rapid, may be justified by economists, but for a generation it has always been injurious to some large segment of the people. Not only are values not maintained; it is fairly evident that many prices are administered, and the relationship of profits to individual prosperity is not evident.



BEST AND WORST: So begins the July syndicated columnist D.J.R. Bruckner, in a piece entitled "The Sufferings of Our Society". On almost the same day I read a report from Mr. Jacque Coe (Cowen & Co.) who is one of the truly brilliant veteran market observers living today. In the light of Bruckner's observations, I was struck by Mr. Coe's second paragraph:

"In the sixty or more years I have been following market movements, studying mob psychology, public participation (or lack of it) in areas of rampant bullishness and despairing bearishness — never but absolutely never have we seen a 50% recovery without some hint of increased public participation". Mr. Coe then points to the overwhelming odd-lot selling during the 1970-71 advance and the first mutual fund selling on balance in the history of the Fund industry.

Whenever something way out of the ordinary occurs, I like to ponder it. Obviously, this market has moved up pretty much on fund and institutional buying — without the help of the public. The public has been occupied in a number of other activities which do not entail buying stocks. For instance, the public has been striking for more money, the public has been trying to make ends meet in the face of the worst inflation in generations. The public has been looking at their neighbors out of work and wondering when it might hit them. The public has been paying for rising taxes, rising food prices, rising living costs and rising blood pressure. Part of the public has dropped out of the whole struggle, gone the blue jeans and organic food route, and part of the public has dropped out of society and sought to support itself via crime (with the population up 13% since 1960, property crime is up 161%).

I thought about all this and about Mr. Coe's observation that we had never seen anything like this lack of public enthusiasm in the face of a big fat recovery in the stock market. And I must say that I've never seen anything like it either. But then, in all fairness, I've never seen the United States in anything like its current mood. I've been trying to put a lot of things together, and I believe the following fits the picture. It is an excerpt from a piece in the June 28 Wall Street Journal by the President of Earlham Collete, Richmond, Va. I was struck by the question and answer, and I reprint it here. The article presents 7 popular views, and an answer to each of them.

5. That this generation's rebellion is essentially the same as all earlier manifestations of youthful revolt against the elders—and will soon pass.

Not so, say the most thoughtful historians, psychologists and social anthropologists—and a lot of commonsense parents and grandparents. The discontent is deeper, more widespread, and more far-ranging in its effects than any "normal youth revolt" ever known heretofore. Even among the "straight kids" who shun both violence and the hippie culture there is great uncertainty about values, attitudes, life styles and goals of family and community. Few American parents can be sure of what their teen-age children really believe about fundamental purposes and values. The elder generation can surely not believe any longer that, "after sowing a few wild oats," today's young will comfortably settle down into the same proper, well established life pattern of their parents.

I ask myself whether there is some fundamental change coming over American society. I ask whether with 18-year olds now voting (and thus providing youth with a bigger hand than ever in America) we are not now facing the early beginnings of a vast change in this land.

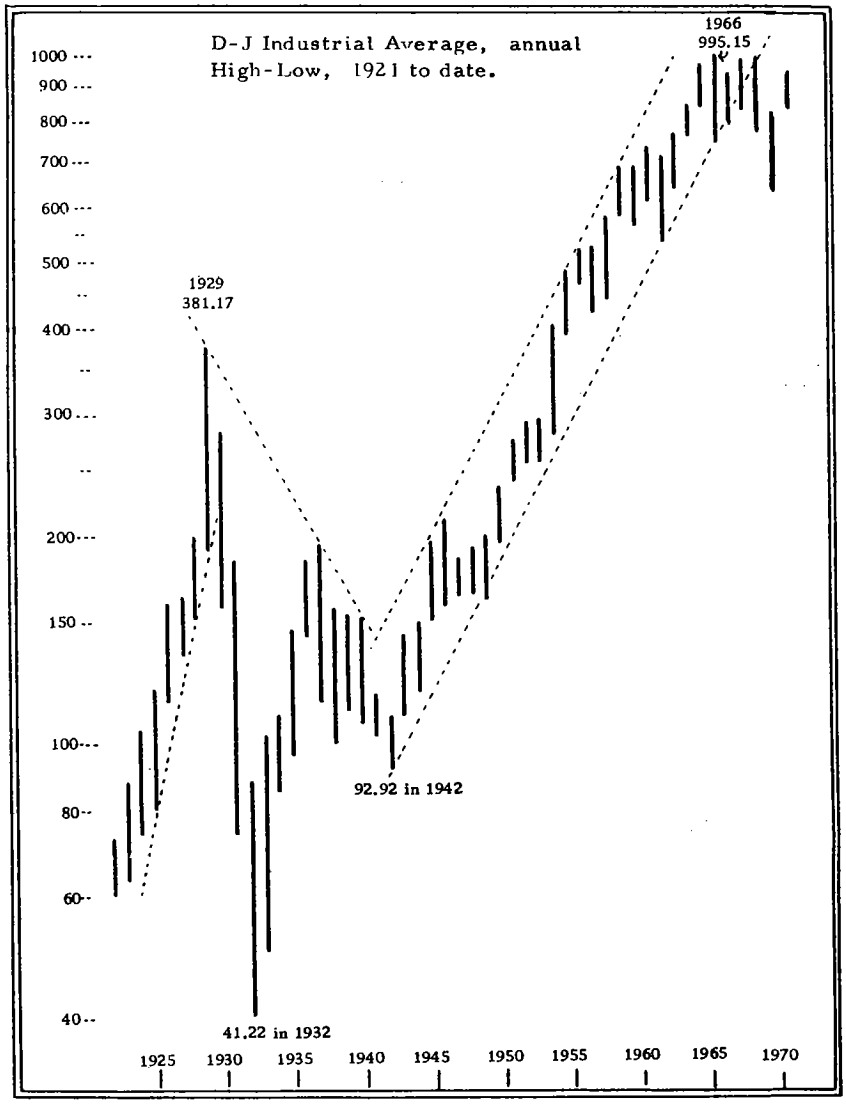
If you read last week's issue of Life, you will note that the veterans are coming out with story after story about atrocities in Vietnam. The atrocities are often blamed on the greed of those in command, the need for the "body count" (a procedure which I always felt was disgusting and immoral). The lying and immorality started at the top and worked its way down. The Pentagon papers document the duplicity and deceit on high, and the actions on the battlefield symbolized the depths to which this war has carried the American people.

I would say that perhaps the outstanding feature of America today is the disillusionment, the distrust with Government and the cynicism regarding what goes on in high places. It was just announced that President Nixon's popularity rating has dropped to 48%, lowest yet, and lower than any of the four preceding Presidents at this point in their time in office. The American people have heard that inflation is the most important problem, that unemployment is the leading problem, that Vietnam is our worst problem, that crime and drugs rate number one, they have heard everything and are beginning to trust nothing. Little wonder, since Wall Street reflects the national psychology, that the public will not flock in to buy a piece of America. From what they see and hear, they're not sure they want it at this time.

"It was the best of times, it was the worst of times". That's pretty much the way I see this nation today. But implicit in that statement is struggle, and I believe that the struggle will be symbolized by the vicious resolution of the primary bear market, a bear market which has been "marking time" since it started in February, 1966.

Perhaps the whole picture can best be appreciated by studying the annual chart of the Dow Industrials which I have included on page 6. Note how the years 1969, 1970 and 1971 have broken out of the pattern which formed ever since the 1942 lows. Note the "feeling" of the Dow hanging in space, the feeling of non-resolution in the pattern. After holding within the rising channel for 27 years, I doubt that the violent break of the last three years can be called an accident. No, I see it as a critically important reversal of the pattern. As time goes on, the reversal will get deeper and more obvious. Then, no one will be able to understand how it was all taken so lightly "in the beginning".

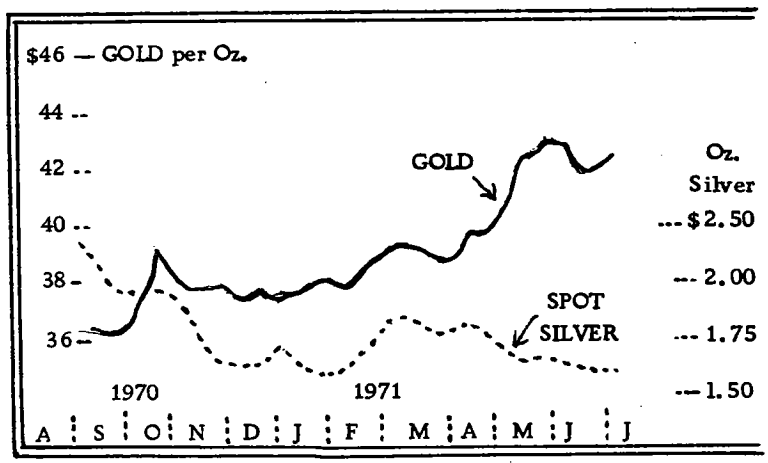
GOLD & SILVER: It has been said (and I agree) that stock market expertise is more art than science. By the same token, I believe that writing a stock market report is more art than science. At any rate, my "artistic instinct" (some refer to it as a "seat-of-the-pants instinct) tells me that it is time to add another regular feature to Dow Theory Letters. With this issue I am including a chart of the spot price of silver and gold (the latter will be the London dollar price of gold as quoted in the Wall Street Journal). This is a weekly chart with postings as of each Monday.

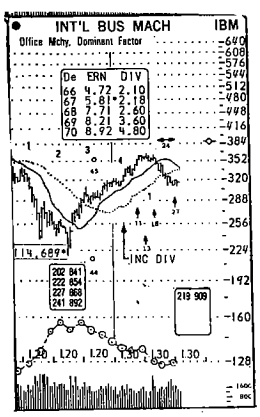


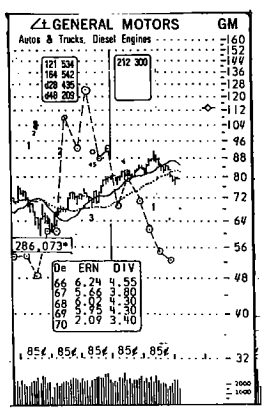
Note that the price of gold is now on the move, and although interest in gold shares is currently minimal, the gold price is now heading for the June peak. If we better the June peak, it would not surprise me to see gold head for the $44-45 per ounce level.

The story with silver is a bit different. When the U.S. Government stopped selling silver early last November, everybody and his brother was loaded with silver and silver contracts on the theory that with the U.S. out of the metal, the silver price had no where to go but through the roof. This may be true, but when everyone is a bull and loaded with silver, the buying is over for a while, and there are only locked-in bulls (or sellers) left. As a consequence of the great, "in-the-bag" silver play, the price of silver has been sagging ever since. I believe silver is about at its low now, and when the last of 1970's bulls has thrown in the sponge, silver will probably be ready for a major upward move.

At present, however, with the dollar on its floor all over Europe and with the U.S. mounting unbelievable trade and budget deficits, gold is the item to watch, and we will watch it in each issue of Dow Theory Letters from now on via this chart.







STOCKS: Two other items to watch are General Motors, the bellwether stock, and IBM, the mammoth glamor stock. A few weeks ago GM made a low for the year, and is now within a few points of that low. New lows for GM have always been a negative indication for the market and the economy. Even more surprising is the new low under 300 for IBM, the darling of the institutions and the leading giant glamor issue. When GM and IBM make lows together, I feel it is an ominous sign. (Chart courtesy of Quote Digest, P.O.Box 213, Wichita, Kansas 67201).